The CANADA ROUND

David E.W. Laidler

SHALL WE ROUND THE GOVERNOR?

A Critique of the Governance of the Bank of Canada

A Series
on the Economics
of Constitutional
Renewal

C.D. Howe Institute

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The Canada Round:
A Series on the Economics of
Constitutional Renewal — No. 1

John McCallum, Series Editor

C.D. Howe Institute

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Foreword

Canada appears poised to embark on an historic political reconfiguration. It is essential that this process be undertaken with a clear and widely diffused understanding of the well-spring of Canadians' economic prosperity.

It is with that in mind that the C.D. Howe Institute presents this series of monographs entitled "The Canada Round: A Series on the Economics of Constitutional Renewal." The series assembles the work of many of Canada's leading economic and political analysts. The monographs are organized around economic themes and attempt to define and examine the economic goals Canadians have set for themselves, as well as the means of achieving them and the influence of alternative constitutional structures.

The series is not meant to alarm or frighten — the process of collective political definition in this country will turn on more than simply questions of dollars and cents. And, as the these monographs reveal, economics rarely produces an open-and-shut case on the superiority of one possible set of rules over another. Even if economics could do this, it would be unwise to assume that economic analysis alone could change the minds of those who are already committed to a particular vision of the political future.

It is equally clear, however, that Canadians now seek greater understanding of the links between the economy, the Constitution, and legal and political life. A significant reform of the Constitution will influence the economy, in some cases for the better; a rending of the Constitution under conditions of acrimony will almost certainly damage it. Thus, the purpose of the series is to help Canadians think constructively about the benefits and costs of alternative constitutional designs.

Underlying the series is a focus on the economic well-being of Canadians, now and in the future. To best insure this over the short

run, Canada needs calm, open negotiations in which efforts are made to understand and incorporate the aspirations of all the participants. This series of monographs is dedicated to that effort.

John McCallum, the Series Editor and Chairman of the Department of Economics at McGill University, organized the intellectual input. Within the C.D. Howe Institute, David Brown, Senior Policy Analyst, played a coordinating role. This first monograph in the series was copy edited by Heather Lange and desktop published by Brenda Palmer. As with all C.D. Howe Institute publications, the analysis and views presented here are the responsibility of the author and do not necessarily reflect the opinions of the Institute's members or Board of Directors.

Thomas E. Kierans
President and
Chief Executive Officer

The Study in Brief

The Bank of Canada is performing well, but it is widely perceived not to be. Therefore, though it is not broken, it still needs fixing.

The Bank's current mandate, drawn up in the early 1930s, requires it to protect the exchange rate and to attempt to stabilize the business cycle. These are the wrong goals for the 1990s. The target of price-level stability is both appropriate and feasible, and the Bank's mandate should be updated accordingly.

The Bank's governance is flawed too. It concentrates power over monetary policy in the hands of the governor and his professional staff, rather than in the Bank's board of directors; and it gives inadequate recognition to the regional disparities of the nation. If Bank directors were full-time appointees, and if the provinces were given some role in their selection, both problems would be eased.

Provided that the Bank remained, as now, clearly accountable to the federal government for its policies, while retaining its independence from day to day political pressures, such changes in governance would probably have little effect on the conduct of monetary policy, but they would give that policy some badly needed political legitimacy.

Introduction

The Context of Reform

Federal institutions will be examined closely in the next year or so. Spicer, Bélanger-Campeau, and all those other commissions and committees too numerous to list, will see to that. The Bank of Canada will be scrutinized along with the rest. Premier Rae of Ontario is surely correct that economic arrangements are a major part of Canada's "real constitution"; and, as the Allaire Report has already recognized, if Quebec seeks a looser political association with the rest of the country while remaining in a Canadian monetary union, changes to the Bank's current mandate and governance will have to be proposed as part of the package.

Quite apart from current constitutional upheavals, a systematic re-examination of the Bank's role in Canada's economic and political life is overdue. The Bank's current mandate is outdated and vague, and the Bank's governance, reflecting its status as an exclusively federal institution, ignores the interests of provincial governments in the conduct of macroeconomic policies. Current arrangements confer on the Bank a high degree of independence from day-to-day political pressure. That, as I shall argue, is very desirable. They also ensure, however, that the power which such independence confers is perceived to be concentrated in the hands of the Bank's governor. The desirability of this is less obvious, as I shall also argue.

Having said all this, it is also important to say that the broad thrust of Bank of Canada policy over the past few years has been, and continues to be, both well conceived and followed with considerable integrity. There is, therefore, an argument to be made that, because the institution is working well, there is no need to tamper with it. The Bank is, however, widely perceived *not* to be working well. Much of this tension, between performance and perceptions, stems from the arrangements under which the Bank currently operates. The suggestions made in this study, then, are not intended to

weaken a federal institution whose capacity to act with integrity is demonstrable, but to strengthen it.

An Outline

I begin by describing the key features of the Bank's mandate and governance as they stand at present, and then criticize certain aspects. I argue in particular that the outdated vagueness of its mandate makes the Bank's degree of accountability for its performance difficult to assess, through no fault of the institution.

After arguing the desirability of maintaining, or even strengthening, the Bank's independence from day-to-day political pressures, I offer certain suggestions for reform — namely, that the Bank's mandate should be updated and clarified to take account of the special powers of monetary policy over medium-term price-level behavior; and that the make-up and role of the Bank's board of directors should be changed so as to strengthen its influence over monetary policy and to ensure that regional interests are visibly represented when policy is designed.

The Current Position of the Bank

Some Basic Principles

It is widely (though not universally) accepted by economists that a market economy's monetary system will not run itself.[1] That system is part of the basic institutional background to economic life, and it is an appropriate function of government to ensure its smooth functioning. Central banks are not indispensable in this role; as we now know them, they are a 19th- and early 20th-century development. The United States did without one until 1913; and closer to

1 Some economists believe that competitive market forces alone could be relied on to provide a stable monetary system. See, for example, F.A. von Hayek, *Denationalising Money* (London: Institute of Economic Affairs, 1976).

home, the Bank of Canada was not founded until 1934. Before then, the tasks that it now performs were shared between the federal Department of Finance and private chartered banks, notably the Bank of Montreal. Even so, in what follows, I take the continued existence of the Bank of Canada for granted, and concentrate on how it might be made more effective.

The principles that should govern such an institution's operations are straightforward. First, its tasks, or mandate, should be clearly stated, those tasks should be feasible, and the institution should be endowed with powers necessary to carry them out. Second, to the extent that the Bank's mandate is related to, or overlaps with, that of other institutions, a framework must exist within which its activities can be coordinated with those of other institutions. Third, in a nation run on democratic principles, where the Bank's mandate is set out in an act of Parliament, the Bank must be subject to the scrutiny of, and ultimately be accountable to, the electorate for the manner in which it fulfills the tasks that it has been given. These principles are surely unexceptionable, but, as we shall see, we do not even have to get into arguments about what difficult words like "ultimately" might mean before their application leads to doubts about the Bank's current position.

The Bank's Mandate and Powers

The Bank of Canada's mandate is laid down in the preamble to the *Bank of Canada Act*. It is:

> to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices, and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada.

So that the Bank may "regulate credit and currency," the act gives it a monopoly of note issue in the country, and certain other powers, the most important of which enable it to deal in various financial assets, and hence conduct open market operations. The act requires the Bank at all times to make public its minimum lending rate — the Bank Rate — and designates it as the fiscal agent of the government of Canada. In this capacity, the Bank manages the federal government's foreign-exchange account and the public debt.

Monetary policy, defined as the regulation of money and credit, interacts with other policy tools available to the federal government. In order to facilitate the coordination of policy, the *Bank of Canada Act* requires the minister of finance and the governor of the Bank to "consult regularly on monetary policy and on its relation to general economic policy." It also provides that, should a disagreement arise between the minister and the governor about the conduct of monetary policy, then

> the Minister may, after consultation with the Governor [of the Bank], and with the approval of the Governor in Council [the cabinet] give to the Governor a written directive concerning monetary policy, in specific terms and applicable for a specified period, and the Bank shall comply with that directive.

Such a directive must be published in the *Canada Gazette* and laid before Parliament within 15 days. This device ensures that the Bank is accountable, through the minister, to Parliament for the way in which it exercises its powers.

In addition to the governor's regular, and private, consultations with the minister of finance, the conduct of monetary policy is nowadays subject to more public parliamentary scrutiny. Parliamentary committees can, and do, invite the governor and other members of the Bank's senior staff to appear before them. In particular, the governor is required to publish an annual report of the Bank's activities. In recent years, the House of Commons Finance Committee has held hearings on that report at which the governor is invited to give evidence and submit to questioning.

The committee gathers information and prepares reports. It has no power over the conduct of monetary policy save that which stems from any publicity its activities may generate. Even so, its hearings should be regarded as a means of keeping the Bank accountable to Parliament, and hence to the electorate, for its conduct.

The Directive and "Dual Responsibility"

There was no mention of the "directive" in the original *Bank of Canada Act*. It is a later addition, stemming from the "Coyne affair" of 1961. Then, the government of the day found itself in conflict with the governor of the Bank, James Coyne, about the stance of monetary policy and the content of certain of his public speeches on the topic of foreign investment in Canada. The government itself initially declared that it had no responsibility for the conduct of monetary policy, and then sought to resolve its difficulties by introducing into Parliament a bill declaring the position of governor vacant. Since the governor then, as now, served during "good behavior", such a bill was open to interpretation as questioning the governor's personal integrity, and though it passed in the Commons, it was defeated in the Senate, after which Governor Coyne resigned.

The device of the directive is designed to handle potential conflict with less confusion and drama than marked the Coyne affair. It is a key component of a system of "dual responsibility" for the conduct of monetary policy. The Bank's responsibility, subject to the mandate given it through the *Bank of Canada Act*, is to set goals of policy and to execute these. The minister's responsibility, should he or she disapprove of the Bank's conduct, is to issue a directive requiring that it follow an alternative of his or her choosing.

This much is written into the *Bank of Canada Act*. What is not written into the act, but was set out in a statement issued by Governor Louis Rasminsky on August 1, 1961, reaffirmed in the Bank's 1963 submission to the Royal Commission on Banking and Finance (the Porter Commission), and stated again in a memorandum submitted by the Bank to the Royal Commission on Financial Manage-

ment and Accountability (the Lambert Commission) in early 1978, is the understanding that if the governor of the Bank cannot in good conscience carry out the instructions contained in that directive, the governor will resign.[2]

The effect of this arrangement, and one that was quite deliberately intended, is to make it always difficult and sometimes embarrassing for the minister of finance to overrule the governor on monetary policy. A civil servant is obliged to carry out the elected government's instructions. The governor of the Bank is obliged to carry out the mandate given to him by the *Bank of Canada Act*. A minister who wished to dismiss a governor, then, would at a minimum have to defend that action by arguing not merely that the governor was unwilling to implement the government's policy, but also that the government's policy was consistent with the act of Parliament under which the governor is obliged to operate.

The Bank's Internal Governance

The Bank of Canada has been a federal Crown corporation since 1938, though it was originally set up as a private company. Formally speaking, it is run by a board of directors consisting of the governor, a senior deputy governor, and 12 other voting directors who are appointed by the minister of finance with cabinet approval. In addition, the deputy minister of finance is a nonvoting member of the board. The board is required to meet at least four times a year, and in practice normally meets eight times. Even so, it delegates its day-to-day responsibilities to an executive committee consisting of the governor, the senior deputy governor, and between two and four members of the full board. This committee meets weekly, and is

2 The phrase "dual responsibility" is taken from the 1963 submission of the Bank of Canada to the Porter Commission (p. 4). The statement issued by Governor Louis Rasminsky in August 1, 1961, was appended to the above-mentioned submission in 1963, pp. 131–132. See Bank of Canada, *Evidence of the Governor before the Royal Commission on Banking and Finance* (Ottawa, May 1964). The Bank's submission to the Lambert Commission was published as "Bank of Canada: Management and Accountability," *Bank of Canada Review*, June 1978.

quorate if only two members attend. The governor is the corporation's chief executive officer.

The *Bank of Canada Act* puts no explicit limits on the powers of the board over monetary policy but in fact the arrangements just described place decisions about such matters in the hands of the governor, who acts in consultation with the senior deputy governor, and on the advice of his professional staff. Though the governor reports to the full board at its meetings, and hears reports from them about economic conditions in various regions of the country, there is no record of his ever having been seriously challenged by the board on a policy matter, let alone overruled. Indeed, the Bank's 1978 memorandum to the Lambert Commission, cited above, makes it clear that the directors are not expected to formulate monetary policy, but rather "to ensure the competence of the Bank's management."

Such limited influence as the board may have over monetary policy mainly stems from the fact that, at seven-year intervals, it appoints (or re-appoints) the governor and senior deputy governor, again with cabinet approval. Otherwise, the legal requirement that its members be drawn from various occupations (though not banking), and the *de facto* practice of ensuring that they fairly represent various regions of the country, might make them a useful source of informal economic intelligence, but no more than that. The fact that board membership is a part-time and modestly remunerated activity further contributes to the body's lack of influence over the conduct of monetary policy.[3]

A Critique of Current Arrangements

An Obsolete Mandate

The Bank of Canada's mandate has not been revised since the 1930s, and therefore reflects the concerns and beliefs of that decade. Its

3 The Bank's current by-laws provide for the directors to be paid $3,000 per annum, $300 per diem for attendance at meetings, and $200 per diem for time spent travelling to and from meetings. Members of the executive committee receive a further $3,000 per annum plus the same per diem allowances.

vague wording nevertheless explicitly singles out two objects for the Bank's attention; namely, the external value of currency and a set of domestic variables, fluctuations in which are usually referred to as the "business cycle." The Bank is expected, as far as is feasible, to protect the former, and stabilize the latter. Such goals must have looked reasonable in the light of the economics of the 1930s, but they look distinctly odd in 1991.

The Exchange-Rate Objective

Consider, first of all, the control and protection of the external value of the Canadian dollar. This goal is an implicit reflection of hopes, widely held in the years following the Great War, but ultimately futile, that the gold standard which had served the international economy so well from the 1880s until 1914 could be restored. Gold had been the international money *par excellence*, and its purchasing power over goods had been (particularly by more recent standards) remarkably stable in those years. A national currency whose value in terms of gold — that is, its external value — was stable would also have stable domestic purchasing power.

Even after the Second World War, when the U.S. dollar replaced gold as the linchpin of the international monetary system, it made sense to treat stability of the exchange rate as a goal of monetary policy so long as the United States maintained a stable price level. The United States has not done that since the mid-1960s. The fact that Canada has maintained a flexible exchange rate since 1971, and that the Bank of Canada has more recently adopted domestic price-level stability as an explicit policy aim, demonstrates that all this is understood. Even so, an important element in the Bank's legal mandate no longer has its original significance and is barely relevant to its current operations.

Stabilization Policy

The second element in the Bank's mandate is to iron out, to the extent feasible, fluctuations in a variety of economic variables. Again, the

relevant passage of the *Bank of Canada Act* must be read in the context of economic knowledge as it stood in the early 1930s, when monetary policy was commonly regarded as the only device available to governments for stabilizing the business cycle.[4] Two relevant developments in economic understanding have taken place since then.

First, the advent of Keynesian economics involved, among other things, the creation of a coherent theory of the use of fiscal — that is, tax and expenditure — policy for such purposes. Second, and more important in the current context, the later development of monetarist analysis brought with it a new and keen appreciation of the difficulties of using monetary tools to stabilize the cycle.

The upshot of all this has been to make economists skeptical about their powers to design effective discretionary countercyclical policies. They now understand that it takes time to recognize the advent of cyclical turning points, more time to design and implement discretionary policy measures, and even more time for such measures to have their effects. As a result, by the time a downturn has been recognized, expansionary measures have been implemented, and those measures have begun to have effects, the economy may already be expanding, and vice versa.

The fear that what are intended as countercyclical measures might turn out to be procyclically destabilizing underlies the stress nowadays laid on creating so-called built-in stability for the economy. On the fiscal front, such stability is enhanced by tax and expenditure systems designed to ensure that the budget balance moves automatically in a countercyclical fashion. In the monetary area, it arises from the authorities ignoring cyclical swings but seeking to stabilize the medium-term time path of the inflation rate. Such policy automatically tends to dampen the cycle's upswing as inflation moves above the long-run trend set by monetary policy, and its downswing as inflation falls below that same trend rate.

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4 It is commonly believed that stabilization policy is an invention of the mid-1930s. This is simply not so. Countercyclical *monetary* policy was much discussed from the 1890s onwards. What the 1930s produced was a theoretical basis for the use of *fiscal* policy for stabilization purposes.

Inflation Targets in Relation to the Present Mandate

There is more to the Bank of Canada's recent adoption, in conjunction with the minister of finance, of explicit medium-term targets for the inflation rate than the creation of built-in stability. The quantitative value of those targets — 3 percent by the end of 1992, 2½ percent by mid-1994, and 2 percent by the end of 1995 — implies a belief, which does not follow from the above argument, that a *lower* stable inflation rate is distinctly preferable to a *higher* one; but their medium-term nature may still be regarded as a well-informed response to the limitations that modern economic analysis suggests surround the use of monetary policy for stabilization purposes.[5] Though the Bank's current policy stance may be interpreted along these lines as consistent with its mandate, it is inconceivable that the mandate would have been set out in the language actually used had its framers believed that discretionary anticyclical monetary policy was neither feasible nor desirable.

More generally, the vagueness of the Bank's mandate as currently set out, its concentration on multiple (and perhaps sometimes inconsistent) goals, to say nothing of the obsolescence of the economic understanding which underlies it, all make it difficult to ensure that the Bank is held accountable for its actions. If Parliament is unclear about what it expects from the Bank, it is bound to find it difficult to decide whether, in any particular instance, the Bank has failed to fulfill its designated task.

The Bank as the Government's Agent

The Bank of Canada has primary responsibility for the conduct of monetary policy. In matters of foreign-exchange operations and debt

5 As Peter Howitt has explained in a recent *C.D. Howe Institute Commentary*, to gear monetary policy to medium-term price-stability goals requires steady money growth, not stable interest rates. Such a policy might produce more volatility in interest rates than has recently been experienced. See Peter Howitt, *A Skeptic's Guide to Canadian Monetary Policy*, C.D. Howe Institute Commentary 25 (Toronto: C.D. Howe Institute, 1990).

management, however, decisionmaking powers are vested in the minister of finance, to whom the Bank is both advisor and agent. Foreign-exchange and debt-management operations overlap with monetary policy, and so the minister's powers over them seem at first sight to introduce an element of ambiguity about the limits of the Bank's independence. In practice, however, this does not seem to be the case. The fact that the *Bank of Canada Act* in effect gives the Bank the power to control the size of its own balance sheet ensures that the influence of the minister over exchange-rate and debt-management policy cannot be used surreptitiously to interfere with monetary policy. This matter is explained further in Appendix A.

Constraints on the Bank's Conduct of Monetary Policy

The Bank of Canada's outdated and vague mandate places few constraints on its conduct of monetary policy. Such constraints as do exist arise from four sources, three of which are the product of the *Bank of Canada Act* — namely, the requirement that the governor consult regularly with the minister of finance; the power of the minister to issue a directive; and any influence that the directors of the Bank might be able to exert on the governor and on the governor's professional staff at their meetings.

Only one of the constraints provided by the act, the directive, would be implemented in public; but it is very much a weapon of last resort and has never been used. The others work behind closed doors, and it is small wonder that no one, least of all this author, has the faintest idea of how important or effective they might be. Note that my complaint is not that the charges of high-handedness, insensitivity, and so on often leveled at the governor of the Bank have any content. It is the more serious reproach that the institutional arrangements under discussion here make it impossible to assess the merits of such charges!

The relatively recently introduced practice of having the governor, on the occasion of the publication of the *Annual Report*, answer

for monetary policy over the previous year to the Finance Committee of the House of Commons is a fourth constraint on the Bank. Though the committee has no executive or legislative authority, it can serve as a focus for the electorate's concerns about the conduct of policy and force the governor to discuss them. Its deliberations thus ensure that the governor hears criticism of Bank policies, and must be prepared to give a reasoned defense of them. Crucially, this fourth constraint operates in public, and can perhaps be expected to affect the nature of private consultations between the governor and the minister. A widely perceived failure of a governor's efforts to defend Bank policies would presumably make the minister more inclined to work for their change and simultaneously render the Bank less able to withstand such pressure.

Regional Interests

An important and long-standing element in popular criticisms of the Bank of Canada is that it pays insufficient attention to the country's regional disparity, while provincial governments more and more present themselves as representatives of regional interests. One does not have to accept this popular view to believe that it requires discussion, nor does one have to welcome the advent of a looser Canadian federation to recognize that, as and if it comes about, it will strengthen the authority of provincial legislatures to scrutinize monetary policy.

This is not to say that regionally differentiated monetary policy could be made feasible in Canada if only the Bank were differently governed. It would not be. The financial system is much too integrated across the country, and Canada's domestic capital market far too efficient and competitive, for it to be conceivable that the Bank could simultaneously maintain low interest rates in depressed regions, and high rates in booming ones, as some of its critics demand.

However, the Bank is also accused, from time to time, of gearing its policy solely to conditions in central Canada, and acting in ignorance of conditions elsewhere. Though the simple fact that, in

recent years, the Governor's *Annual Report* has paid considerable attention to developments outside central Canada would seem to be evidence against this accusation, it is nevertheless the case that the current governance of the Bank recognizes regional interests only in the *de facto* makeup of its board of directors, and otherwise ignores the federal nature of the Canadian polity. If nothing else, this state of affairs surely affects the public's perception of the Bank's sensitivity to regional issues, and in such matters perceptions can be important.

Central Bank Independence

Some Preliminaries

My views on how the mandate and governance of the Bank of Canada might be improved are implicit in the foregoing commentary, but before turning to the task of making them explicit, the thorny problem of the Bank's degree of independence from political pressures and control must be addressed in more detail.

The system of dual responsibility for monetary policy outlined earlier in this study confers upon the Bank considerable independence. Though the system as it now exists is a product of the 1960s, such independence was high on the priorities list of the Bank's founders in the 1930s. That it was desirable for a central bank to be well insulated from short-term political influence was the conventional wisdom of the day. After falling into a certain amount of disrepute in intervening years, such a viewpoint is once again respectable.

Many central banks, particularly in the British Commonwealth and Western Europe, nowadays enjoy markedly less political independence than the Bank of Canada, but the Canadian situation is far from unique. The central banks of, say, Austria, Germany, and Switzerland are even less under the sway of politicians. Closer by, the U.S. Federal Reserve System also enjoys a high degree of political independence. Certain features of the Federal Reserve System are described in Appendix B. The most notable of these is that, although the system is well insulated from politics, its chief officer, the chair-

man of the Federal Reserve board, seems to enjoy rather less personal authority over policy than does the governor of the Bank of Canada. It is clearly important to distinguish questions about central bank independence from those concerning the powers of its governor, and I return to this second set of issues below.

The Traditional Case for Central Bank Independence

The traditional case for insulating any central bank from political control has not changed in essence since 1802, when it was set out in Henry Thornton's famous *Paper Credit of Great Britain*, the first work systematically to analyze the Bank of England's position and performance as a central bank.[6] That case was eloquently made by Bank of Canada Governor Louis Rasminsky in a 1966 lecture to the Per Jacobsen Foundation, and quoted at some length in the Bank's 1978 memorandum to the Lambert Commission cited earlier. It rests on the observation that politicians with power over monetary policy in effect control the means of creating money, and are open to constant temptation to use that power in an inflationary fashion.

They are subject, on the one hand, to the pressures of particular interest groups, each intent on obtaining costly favors from government, and on the other from taxpayers who are always reluctant to provide the funds to pay for them. The incentive to deficit finance is thus ever-present, and a government that has ready access to a printing press is more likely to indulge in this, and monetize resulting deficits, than one that must borrow from skeptical participants in domestic and international capital markets. An independent central bank, then, is an important bulwark against inflation. As Governor Rasminsky put it, "a wide separation between the power of the government to spend money and the power to create it is necessary if the latter power is not to be misused."

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6 See Henry Thornton, *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain* (1802), edited with an introduction by F.A. von Hayek (London: George Allen and Unwin, 1939).

Is Central Bank Independence Antidemocratic?

Against this traditional case, it is frequently urged that there are other values to be considered in the design of political and economic institutions far more important than those associated with price-level stability. In particular, it is often urged by the opponents of central bank independence, and sometimes conceded by its defenders, that large elements in the case are "antidemocratic." Such criticism is, I believe, largely misplaced.

That democratic politics make it difficult for governments to resist the blandishments of interest groups to spend, and of the population at large not to tax, is true enough. However, anyone who believes that there is something unique about the tendency of democratic institutions to deliver deficits and threaten inflation should consider the fiscal and monetary histories of various totalitarian regimes in Latin America, Africa, and Eastern Europe. Interest groups may take different forms and operate by different means under nondemocratic regimes, but they neither cease to exist nor become less effective. The problem of constraining them is one of political organization in general, not just of democratic political organization, and goes far beyond questions of central bank independence.

The characterization of parliamentary government as "elected dictatorships," and the associated slogan "let the people decide," are being rather widely heard in Canada at the moment. Such sentiments are more accurately described as populist than democratic, and those who doubt the efficacy of government by frequent referenda or the desirability of making members of Parliament subject to recall by their constituents are not necessarily totalitarians. In Canada, they are more likely to be thoughtful observers who believe that full-time elected politicians and their bureaucrat assistants are better able to produce coherent and well-informed policies than *ad hoc* citizens' committees on this, that, and the other. Those same observers may also believe that elected politicians' chances of success in designing coherent and responsible policies will be enhanced if they are re-

quired to formulate them within a well-understood and stable constitutional framework.

This controversial viewpoint is nonetheless intellectually respectable, making it as easy to defend central bank independence as a desirable component of the constitutional framework within which representative democracy can function effectively as to attack it as an elitist intrusion into the workings of democracy. What, after all, is undemocratic about defending the stability of the economy, and indeed the polity, against the economic consequences of the narrowly focused and short-sighted activities of interest groups?

The test of central bank independence from this point of view is not whether it conforms to some abstract principle about always involving "the people" in formulating policy, but whether it helps or hinders the maintenance of the political-economic stability in which such democracy can flourish. It is, therefore, worth pointing out that a number of academic commentators, notably Robin Bade and Michael Parkin, and more recently Alberto Alesina, have found an intriguing empirical association between the degree of independence that a country bestows on its central bank, on the one hand, and its success in avoiding inflation, on the other. Indeed, political independence seems to be a much better predictor of a central bank's ability to deliver price-level stability than the presence or absence of an explicit mandate to aim for such a goal in the legislation under which it operates.[7]

Central Bank Independence and Stabilization Policy

One's willingness to be swayed by such an argument depends on a particular view of how the monetary system impinges on the rest of the economy, and how political processes might affect monetary

7 See Robin Bade and Michael Parkin, "Central Bank Laws and Monetary Policy" (University of Western Ontario, London, 1987, mimeographed), which builds on preliminary work carried out in the later 1970s; and Alberto Alesina, "Politics and Business Cycles," *Economic Policy 1990*.

policy. In the heyday of Keynesian economics, it was widely and sincerely believed that monetary policy could and should be used in coordination with fiscal policy actively to stabilize an economy otherwise prone to dangerous oscillations. It was also believed that monetary policy had no special influence on inflation that set it apart from fiscal policy. Indeed, "incomes policies" and "wage-price guidelines" of various sorts were given pride of place here.

From such a standpoint, it seemed to make good practical sense to have authority over monetary and fiscal policy located in the same place. That is why, from the 1940s until well into the 1960s, and in a number of countries, central banks became increasingly subservient to ministers of finance. It is also one reason why a large part of the Canadian academic community sided against the Bank of Canada during the Coyne affair. At that time, the Bank was emphatically not carrying out a monetary policy designed to support the government's Keynesian fiscal stance.[8]

Because I do not set any store by the efficacy of monetary policy as a tool of fine tuning, or by income policies as devices for controlling inflation, and because I do worry about the dangerous inflationary consequences of monetizing fiscal deficits, I favor a considerable degree of central bank independence.

To favor central bank independence, it should be stressed, is not also to favor secrecy and immunity from public criticism. Closely related, and to return to a point raised earlier, it is also important to distinguish between the individual independence of the governor of the Bank and that of the institution. A more precise specification of my views on these matters will emerge in the course of the discussion that follows.

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8 On this matter, and indeed for a view of central bank independence different to the one taken in this study, see H. Scott Gordon, *The Economists versus the Bank of Canada* (Toronto: Ryerson Press, 1961). This classic polemic is one of the positive products of the Coyne affair. A more academic treatment of the principles involved is to be found in the same author's "The Bank of Canada in a System of Responsible Government," *Canadian Journal of Economics and Political Science* 27 (February 1961).

Some Specific Suggestions for Reform

An Overview

The *Bank of Canada Act* is a product of the 1930s, and received its last significant amendment — the introduction of the device of the "directive" in the wake of the Coyne affair — in the 1960s. Small wonder, then, that it is badly adapted to the political circumstances and state of economic knowledge of the 1990s. A commentary such as this is not the place to attempt to redraft an act of Parliament, and in any event, that is a task for a lawyer, not an economist. What follows, then, is a set of suggestions, some more definite than others, about the framework that a redrafted *Bank of Canada Act* might try to create. I make no attempt to find the precise form of words that would accomplish any particular end.

I begin with the Bank's mandate, and then I turn to measures to adapt the Bank's political standing to the already rather decentralized nature of the Canadian federation, measures whose desirability would be enhanced should current constitutional upheavals lead to further devolution of powers to the provinces. In the course of this discussion, I suggest ways of altering the Bank's internal organization so that the powers of the board of directors *vis-à-vis* the governor may be strengthened. The overall aim is to match the Bank's mandate to its capabilities, and to make it more open to criticism and debate, and hence more accountable for its performance, without increasing direct political control over its actions.

Reforming the Bank's Mandate

The obsolescence of the Bank's present mandate was discussed earlier. Suffice it here to recall that, sensible though it might be to gear monetary policy to managing the exchange rate against the background of a gold standard, or in the presence of an international currency of stable purchasing power such as the U.S. dollar was until

the mid-1960s, neither precondition currently exists; and that, optimistic though economic opinion once was about the capacity of monetary tools to help stabilize the cycle, such optimism has proved ill-founded.

The Bank's old mandate should therefore be replaced with clear instructions to do what it is capable of doing — namely, maintain medium-term domestic price stability. A number of countries that have recently revised their central bank laws have taken such action. Thus, the 1984 Austrian National Bank Act requires that institution "to ensure with all the means at its disposal that the value of the Austrian currency is maintained with regard both to its domestic purchasing power and to its relationship with stable foreign currencies." Since 1989 in New Zealand, it has been "the primary function of the [Reserve] Bank...to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices." These would be excellent examples for Canada to follow.[9]

Price-Level Predictability and Stability

Two dimensions of price-level behavior are important to a revised mandate for the Bank of Canada — namely, predictability and stability. In my view, the Bank should be asked to aim at both. It should be pointed out, however, that current economic opinion is more unanimous about the desirability of the first of these goals than the second.

Price-level predictability is desirable for the perfectly straightforward reason that money is the economy's unit of account, and that many stores of value in which agents hold their wealth are denominated in money terms. Any contract that involves the passage of time and is denominated in money, therefore, is liable to be

9 On Austrian central bank law, see Eduard Hochreiter, "The Austrian National Bank Act — What Does It Say about Monetary Policy?" (Austrian National Bank, Vienna, 1990, mimeographed). On New Zealand, see Reserve Bank of New Zealand, *Monetary Policy Statement* (Wellington, April 1990).

disrupted by unpredictable changes in the price level; wealth, too, is redistributed between debtors and creditors in an arbitrary fashion. To render price-level changes predictable is to enable agents to take account of them in the arrangements they make, and hence to protect themselves from these consequences. That is why this goal is so widely regarded as desirable.

Price-level stability is more controversial simply because reasonable people can and do disagree about the extent to which agents are able to arrange their own protection against price-level changes, if these are foreseen. The proponents of price-level stability point to the far from complete indexation of the tax system, and to the apparently insoluble difficulties of adapting to chronic inflation the accounting systems on which business relies for planning purposes. They also tend to be skeptical about claims that money, wages, and prices are downwardly inflexible to the point of introducing serious frictions into the working of a low-inflation economy. On the other hand, opponents of price-level stability worry less about the distortions introduced into economic decisionmaking by moderate inflation rates, and seem to be particularly concerned about downward wage and price stickiness, which would, if important, cause a low-inflation economy also to be a rather low-employment economy.

Elsewhere, I have made it abundantly clear that I favor price-level stability as a goal for monetary policy, and I have argued that, in practice, this should involve trying to keep the annual rate of increase of the Consumer Price Index in the 0–2 percent range.[10] The new mandate of the Reserve Bank of New Zealand referred to earlier, has indeed been supplemented by an agreement between that bank and the New Zealand minister of finance to achieve and then maintain inflation in just such a range. A case can be made for giving the Bank of Canada such a *quantitative* goal as well.

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10 See my contribution to R.G. Lipsey (ed.), *Zero Inflation: the Goal of Price Stability* (Toronto: C.D. Howe Institute, 1990). This volume and its companion, R.C. York (ed.), *Taking Aim: The Debate on Zero Inflation* (Toronto: C.D. Howe Institute, 1990), contain a comprehensive collection of papers dealing with the cases for and against the Bank's current policies.

The joint adoption by the minister and the Bank of quantitative medium-term inflation targets on the occasion of the introduction of the 1991 budget involves a large step in that direction. The announcement stops short of writing such targets into an act of Parliament, however. Such a measure would, in my view, be desirable, if only because an amendment to the *Bank of Canada Act* would then be needed to set those targets aside in future.

However, to replace the Bank's current mandate with a clear *qualitative* instruction to maintain a predictable and stable price level represents a sufficiently large improvement that one would gladly settle on such an outcome. I would not favor any attempt to constrain the Bank in the pursuit of this goal by imposing any rules concerning money growth or the like, as I explain in Appendix C.

Strengthening the Bank's Board

As I pointed out earlier, desirable though it is that the Bank of Canada maintain a good deal of independence from elected politicians, it by no means follows from this that the power implied by such independence should appear to be wielded by one person. It should be stressed that this is not to criticize the policies followed by the Bank under Governor Crow. Their explicit aim, after all, has been one that I would like to see written into the Bank's mandate, and, broadly speaking, their execution has been technically consistent with achieving that aim.

Nevertheless, monetary policy has been widely portrayed as reflecting the views (stronger words such as obsession or mania have sometimes been used) of one unelected official who is also alleged to be, among other things, insensitive to the regional diversity of Canada. The minister of finance has defended monetary policy against attacks in the federal Parliament, and has now included inflation targets agreed with the Bank in a budget statement. The governor has also spoken publicly in his own defense. Even so, monetary policy has had support neither from non-Conservative federal politicians nor from provincial politicians of any stripe.

Anyone concerned with maintaining the political legitimacy of the Bank of Canada should be deeply worried not just that its policy commands such slender political support, but also that criticism of policy so frequently takes the form of personal attacks on the governor. The situation could, I believe, be greatly improved by strengthening the board of directors of the Bank, and ensuring that the design and defense of policy became, and was seen to have become, a matter for the whole board.

Provided that the directors were well qualified to occupy such a position and had ample time to devote to exercising their responsibilities, I can think of no reason why, on average, the conduct of monetary policy would be much different from what it is at present — though the details might, of course, differ from time to time. The public image of policy, however, would be much improved. It would be seen to be the result of the careful deliberations of a committee of well-informed experts, and it could not be misrepresented, as it too often is at present, as reflecting the whim of one person.

Moreover, if Bank directors were able to speak publicly about policy on the same terms as are now available to the governor and his senior staff, the Bank's case would get a much better and more frequent hearing than it now does. Finally, the existence of a stronger board, on which the various regions of the country were seen to be fairly represented, would make it far harder to level ill-informed and irresponsible charges of regional insensitivity at the Bank.

And how would this be accomplished? First, the position of Bank director should become full time. The *Bank of Canada Act* gives directors the responsibility of running the Bank, but by making the position a poorly remunerated and part-time affair, it effectively forces the board to delegate responsibility for monetary policy to a governor supported by a small executive committee with minimal quorum requirements. When a need for speedy action precludes the calling of a board meeting, the governor could, as now, act on behalf of the board, but in full knowledge that he would in due course be accountable for his decision to a well-informed body with real powers.

At present, directors of the Bank cannot be drawn from the banking industry, and once appointed must divest themselves of any bank stock that they might own. These are reasonable enough precautions against conflicts of interest, but they have the unfortunate effect of excluding from the Bank's board a large number of able people whose experience and expertise would make them particularly well-informed and valuable contributors to the design of monetary policy. If positions on the board were full time, an exclusion of bank officers and employees would be unnecessary. Anyone appointed a full-time director would have to give up other employment, and the maintenance of current divestiture rules would eliminate any remaining conflicts of interest. Thus, a full-time board of directors could also be a better-qualified one.

There is, of course, the question of the size of the board. It is hard to see how 12 full-time directors could be kept occupied, and since they would have to be well paid, the expense of such a large board might also be hard to justify. I have no strong feelings about this matter, but perhaps a board whose voting members included the governor, and two or three deputy governors — instead of, as at present, just one — along with, say, six outside appointees would be big enough to function effectively. And the desirability of keeping the deputy minister of finance as a nonvoting member of the board seems uncontroversial.

The Question of Regional Representation

Directors of the Bank are already selected with a view to achieving a reasonable balance of regional representation on the board, but the *Bank of Canada Act* says nothing about this, referring only to the maintenance of a balance among various occupations on the board. It would seem reasonable, and uncontroversial, to suggest that the act should be amended to reflect the *de facto* situation.

Canada is a rather loose federation, and provincial governments already presume to represent regional interests in the national

arena through such institutions as first ministers' conferences; they will presumably continue to do so, and if the current constitutional crisis is resolved by a significant devolution of powers to the provinces, the legitimacy of their claims in this regard will be enhanced.

As I have already mentioned, provincial politicians also feel free to pronounce on matters of monetary policy. Such comment is always irresponsible in the technical sense that provincial governments have no jurisdiction over such policy, but it is also often irresponsible in the more general sense of being ill-informed and mischievous. The second characteristic is a natural result of the first. Politicians with no influence, and no prospect of influence, over important policy measures have every incentive to play to the gallery when they discuss them, and no incentive to inform themselves about the issues involved before they do so.

At present, directors of the Bank of Canada are appointed by the federal government, and that is where ultimate decisionmaking power would have to remain so long as the Bank was expected to make policy for a Canadian federation. The Bank is responsible for executing the wishes of the federal Parliament as expressed in the *Bank of Canada Act*, and if its officials are to be held accountable for their performance, then their appointment must surely be in the hands of a minister responsible to that Parliament. Nevertheless, directors could be selected from short lists of candidates put forward by provincial governments in particular regions provided that, and in keeping with the fact that the Bank is a creation of the federal Parliament, it was clear that the minister of finance had no obligation to accept particular nominations and, indeed, had the right to reject entire short lists if need be.[11]

11 I do not believe that the idea of giving each province its own representative on the Bank's board has much merit. The idea of Prince Edward Island having equal representation to that of Ontario or Quebec seems absurd. See also my comment on the desirability of keeping the board relatively small. If there were six outside directors, two could represent Atlantic Canada, one Quebec, one Ontario, one Manitoba and Saskatchewan, and one Alberta and British Columbia. This author lacks the expertise to comment on whether it is constitutionally and legally proper for Quebec to have a representative on the board of a federal crown corporation should it cease to send members to the federal Parliament.

Directors selected from regional lists could be expected to speak publicly about the Bank's policies in their areas; and their presence on a board that itself had real power would give a certain legitimacy, sadly lacking at present, to monetary policy in regional political arenas. If the Canadian federation becomes less centralized than it now is, the desirability of such legitimacy will only be enhanced. Moreover, the very fact that provincial politicians had a hand in nominating directors might also make those politicians a little more thoughtful in their criticisms of monetary policy than they routinely are at present.

One further change would seem desirable here. Directors of the Bank are currently appointed for three years. If the board is to be strengthened, if provincial politicians are to be given a hand in nominating its members, if actual appointments are still to be left in the hands of the federal government, and if it is simultaneously desired to maintain the Bank's political independence, this period should be lengthened well beyond the term of the elected politicians involved in the appointments. Positions on the board might, then, be held for periods of seven or 12 years, and directors should serve, as does the governor, during their good behavior.

Relations with the Federal Government

Making regional representation on the Bank of Canada's board both more effective and more visible cannot alter the fact that the Bank is primarily a federal institution, and as such must ultimately be accountable to the Canadian Parliament that created it. I have already described above the system of "dual responsibility" under which monetary policy is now made. I have also defended the considerable degree of independence that this confers on the Bank, and I see no reason to change this aspect of current arrangements. To be sure, I have suggested that the Bank's board be strengthened *vis-à-vis* the governor, but this makes it no less desirable than it is at present that the governor and the minister of finance consult regularly about

monetary policy, or that the minister be represented at board meetings by his deputy.

Since the minister of finance is ultimately responsible to the federal Parliament for national economic policy, it is also desirable that he retain the power to issue a directive to the Bank in the case of disagreement, and that this power remain exclusively a federal one. Consultation with the governor, or perhaps with the Bank's board, should be a necessary prerequisite to the issue of a directive. Since someone within the Bank must take ultimate responsibility for its policies, it should be incumbent on the governor, and any directors who support him (presumably a majority), to resign on receipt of an unpalatable directive.

If anything, I would expect that the existence of a strengthened board, charged with exercising a rather precisely defined mandate, would make it even more difficult than it is at present for a minister to issue a directive, but that does not mean that the Bank in the longer term would be more insulated from the ultimate control of the electorate than it is now. Directors' initial appointments might be staggered in such a way that, subsequently, vacancies would be filled on the board at rather regular intervals, thus enabling the minister, working with provincial governments, slowly to influence its complexion over time.

Moreover, directors with real power could not expect to be immune from questioning by parliamentary committees of a type now reserved mainly for the governor. With more individuals carrying responsibility for policy, this type of monitoring could be much more frequent than it now is, and it would also give a platform from time to time to directors who found themselves in disagreement with the majority of their colleagues. Whether such examinations took place solely in the federal Parliament, or were extended to provincial legislatures too, would, presumably and among other factors, depend on the rules of particular bodies.

To open up the monetary policymaking process to scrutiny in this way would ensure that responsible political opinion was heard when policy was designed, and could only be ignored if there were

good arguments for doing so. Though I suspect that this is the case already, it is not seen to be the case — a politically unhealthy state of affairs that does nothing to strengthen the Bank of Canada's capacity to remain independent in the longer run.

The changes I suggest here, then, should strengthen the Bank's ability to take politically unpopular but economically desirable decisions, not weaken it, while at the same time ensuring that it remained ultimately accountable for its actions to the electorate. And, of course, it should be remembered that it is within the powers of Parliament to exercise ultimate control over monetary policy at any time by amending the *Bank of Canada Act*.

Concluding Comment

The message of this study is easily summarized. The *Bank of Canada Act* as it currently stands is obsolete and ambiguous. Even if Canada faced no other constitutional questions, it would be worth some effort to bring it up to date. At a time when all federal institutions are under suspicion, this need is even more pressing. The specific proposals for reform set out here are advanced tentatively, in the hope that they might form a basis for further debate rather than as a set of cut-and-dried and obviously desirable measures.

Appendix A

Ministerial Power over the Foreign-Exchange Market and Debt-Management Operations

Suppose that, under a flexible exchange-rate regime such as Canada now has, the minister of finance felt uncomfortable with the level of the exchange rate. It would seem to be open to him to have the Bank intervene on his behalf in the foreign-exchange market so as to ease any tendency of the Canadian dollar to appreciate, or indeed to cause it to depreciate. However, the extent to which such actions initiated by the minister could interfere with the thrust of monetary policy is limited by the fact that the Bank is under no obligation to provide him with Canadian dollars newly created for this purpose.

If the Bank did not wish to ease monetary policy, then the Canadian dollars needed for the operation would have to be borrowed domestically, and the upward pressure that such borrowing would put on domestic interest rates would, in the longer run, work against the minister's attempt to ease the exchange rate. Thus, the Bank's role as the minister's agent in the foreign-exchange market gives the latter very little scope to interfere with monetary policy, and under Canada's current flexible exchange-rate regime does not seem ever to have led to difficulties in practice.

Some commentators have argued that advantages could be gained on the international trade front by giving up an independent monetary policy and simply tracking the monetary policy of Canada's largest trading partner, the United States; and that fixing the exchange rate on the U.S. dollar would accomplish this.* To take such a step would involve the surrender of an important (certainly symbolic and perhaps substantive) element of Canadian political sovereignty. Whatever we may think of such a measure, we would surely

* See, for example, the section entitled "The Exchange Rate and the Free Trade Agreement," of Thomas J. Courchene, "Rethinking the Macro Mix: The Case for Provincial Stabilization Policy," in Robert C. York, ed., *Taking Aim: The Debate on Zero Inflation* (Toronto: C.D. Howe Institute, 1990).

want the power to take it vested in our elected representatives, not in the governor of the Bank. That is, indeed, how things are now arranged. Any governor who opposed a political decision concerning the change of exchange-rate regions would surely be open to a directive that could be issued with little risk of embarrassment to the government. If the Bank's mandate were revised along lines I have suggested, however, a change in the exchange-rate regime might require that the *Bank of Canada Act* be amended.

In short, the degree of ambiguity about responsibility for the exchange rate that at first sight appears to be implicit in current arrangements turns out, on closer inspection, to be of no importance. The case seems to be the same with regard to the minister's powers *vis-à-vis* debt management. Monetary policy works through its effects on private-sector liquidity and, hence, spending decisions; but variations in the quantity of banking-sector deposit liabilities, a key variable in its conduct, are not the only source of changes in the private sector's liquidity.

Short-term government securities are more liquid than long-term debt, and so changes in the maturity structure of the federal debt, a matter of debt-management policy, are, from a broader perspective, also monetary policy measures. The minister of finance can, in principle, implement what amounts to a loosening of monetary policy by shortening the maturity of the public debt, and a tightening by lengthening it.

One of the ironies of the Coyne affair was that the monetary tightness during 1957–61 which led to so much conflict between Bank and minister, stemmed in part from a debt-management operation. The so-called Conversion Loan of 1958 was the result of a cabinet decision, not a unilateral act on the part of Governor Coyne, and it greatly lengthened the average maturity of the federal debt.[†]

† For an account of the cabinet's role in implementing the Conversion Loan, see Donald Fleming, *So Very Near* (Toronto: McClelland and Stewart, 1985), chap. 45. The operation itself involved exchanging large amounts of debt, originally issued in wartime and soon to mature, with new long-dated government securities in order to make future debt-management operations easier to conduct.

However, the conversion loan was certainly undertaken on the advice of, and with the full support of, the Bank, and it is hard to believe that it would have been undertaken in the absence of such advice and support.

More generally, the finance minister's powers over the maturity structure of the public debt do not extend to the size of the note issue, or the volume of Bank of Canada deposit liabilities. Since the size of the Bank's balance sheet is by far and away the dominant factor influencing the private sector's liquidity, and since the Bank has sole decisionmaking powers over this variable, its role as the minister's agent *vis-à-vis* other respects of the public debt does not, in practice, put any important limits on its independence.

Appendix B

Some Features of the U.S. Federal Reserve System

The legislators who designed the U.S. Federal Reserve System were well versed in the conventional wisdom of the day about the desirability of insulating the central bank from political pressures. To that end, they created in 1913 a system independent of the federal legislature, and only indirectly open to influence by the executive branch of government.

Regionally based populism was of considerable significance in U.S. politics of the time, and this was (and is) reflected in the fact that the system consists not of one bank, but of a federation of 12 regional banks overseen by a board of governors based in Washington. The original intention, in keeping with populist thought, was to have a system that permitted regionally diverse monetary policy, but this, of course, proved impossible. Since the 1930s, monetary policy has been made in Washington and executed in New York for the whole of the United States by an institution that nevertheless maintains much of the political independence granted to it by its founders.

Key factors promoting the independence of the Federal Reserve's board are that the terms of office of its members — 14 years — are far longer than that of the president, and that the timing of the appointment of its chairman does not coincide, except by accident, with any date in the U.S. election cycle. Such direct political constraints as exist on the conduct of monetary policy in the United States mainly arise from the requirement that the chairman of the board of governors report regularly to, and submit to public questioning by, members of Congress.

Less directly, monetary policy is politically constrained by the president's power to appoint new members to the board of governors of the Federal Reserve System as vacancies arise. Membership of the board of governors is a full-time and (by the standards of the U.S. federal government) well-paid position, and members of the

board of governors have much more power relative to the system's chairman than do directors of the Bank of Canada relative to its governor. By changing the board's complexion as and when the opportunity presents itself to make new appointments, the president can, in the longer run, exert an incremental influence to the thrust of monetary policy.

The power of governors of the system stems from the fact that monetary policy decisions in the United States are made not by the chairman of the system on the advice of professional advisors, but by the federal open market committee, of which all members of the board of governors are voting members. The committee also includes five other members chosen by rotation from among the presidents of the 12 regional Federal Reserve banks, who in turn are appointed by and responsible to the boards of directors of those regional banks, rather than being beholden to the governors of the system for their positions.

Not only, therefore, can indirect political pressure be brought to bear on monetary policy in the United States through the powers of newly appointed governors, but regional interests, too, are able to make their presence felt when important decisions are made. It is difficult to say whether all this adds up to significantly less political independence for the Federal Reserve than is enjoyed by the Bank of Canada, but the chairman of the system probably enjoys less personal authority over policy than does the governor of the Bank of Canada.

Appendix C

Monetary Rules

To argue the desirability of giving the Bank of Canada a quantitative price-level target implies a belief that there exists a set of policy measures which will enable such a goal to be achieved. The question must arise, therefore, as to why one should not write its mandate in terms of those measures themselves, rather than the goal they are expected to achieve.

I have argued elsewhere that, in current circumstances, an inflation rate in the 0–2 percent range can best be achieved by maintaining the growth rates of selected monetary aggregates in particular ranges — around 3 percent for M1 and 5 percent for M2. Why not, then, write money growth targets into the Bank's mandate and be done with it. Such a measure was recommended for the United States by Milton Friedman in 1961,* and the "money growth rule" has found many supporters since then.

The difficulty with any such proposal is that quantitative estimates of the money growth rates required to bring about price-level stability in Canada, or anywhere else, for that matter, are very much conditioned by the structure of the financial system as it currently exists; but there is no reason to believe that the structure in question is immutable. Indeed, Canada has already lived through one example of institutional change in the financial sector helping to undermine previously reliable quantitative relationships.

In 1975, under the label of "gradualism," the Bank of Canada imposed money growth targets on itself, only to see the significance of its chosen aggregate, the narrow M1, change in subsequent years and render those targets inappropriate. Though the financial system seems to have settled down again, it is of the very essence of institutional changes that they are unpredictable. To write money growth rules into the Bank's mandate, therefore, would be to ask for trouble.

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* Milton Friedman, *Program for Monetary Stability* (New York: Fordham University Press, 1961).

Two ways of dealing with such problems have been advocated. The first, associated with the late Karl Brunner,* would involve devising a "meta-rule" — a rule for changing the rules — to cope with institutional change. Unless one was endowed with enough foresight to enumerate all the possible forms such institutional change might take, however, it is hard to see how one could devise a meta-rule that was not itself potentially vulnerable to the phenomenon. The alternative, which has recently been elaborated by Peter Howitt,† is simply to bow to the inevitable, and realize that, though it might make sense to legislate the ends of monetary policy, it is unwise to try to legislate the means.

Though this latter position seems to me to be the only defensible one, it brings problems with it. If it really were possible to tie down the means of monetary policy by legislated rules, then the political oversight of the Bank would present only managerial issues. Either the bank would be carrying out its instructions or it would not. However, if there must be an important element of discretion in the conduct of monetary policy, then questions arise about the degree of independence to be granted to the Bank, about how to expose it to criticism, and about how to ensure that it is held ultimately responsible to the electorate.

* See Karl Brunner, "Monetary Policy and Monetary Order," *Aussenwirtschaft* 39 (1984).

† See Peter Howitt, *A Skeptic's Guide to Canadian Monetary Policy*, C.D. Howe Institute Commentary 25 (Toronto: C.D. Howe Institute, 1990).

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* The views expressed in this publication are those of the author, and do not necessarily reflect the opinions of the Institute's members.

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